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Bruce Greenwald on Value Investing

American Express, WellPoint top the noted professor's list.

By Kirk Shinkle
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Bruce Greenwald, who holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School, is coeditor of the forthcoming sixth edition of the value investing classic *Graham and Dodd's Security Analysis* (McGraw Hill).

After watching stocks plummet this year, he's sizing up the opportunities seen through the lens of value greats like Warren Buffett who perceive a rare chance to start buying on the cheap. Excerpts:

What's the current environment like for a value guy?

I'll tell you the one really nice reason to be a value investor: When things like this happen, you cannot help but go nuts at the opportunity. What this looks like is the end of 1974, where good stocks are selling at three times sustainable earnings and stocks that normally wouldn't have sold at less than 20 times earnings are selling at 10 times earnings. These are exciting times. The short-term issue is that in the near term there will be a painful macroeconomic environment and we don't know how long it will last.

What should investors eyeing cheap stocks watch out for?

The craziest thing to do is take recent earnings and add a multiple to it. There are a lot of stocks, like steel companies, that have very high recent earnings and trade at only four to five times earnings. They look like a 20 percent return stock, but those earnings won't be sustainable. If you look at steel companies five years ago before this huge capacity run-up, their earnings were about a third to a quarter of what they are now. You have to stay away from those kinds of enthusiasms —things that look cheap on the basis of peak earnings. You're looking for [stocks] that are protected by assets.

How should you approach earnings predictions?

What you don't want to do is use unmoderated price-to-earnings. Never look at current or even recent earning, especially in areas like oil companies where we know they are inflated and coming down. Typically, what a value investor will do first is get a sustainable earnings number, an average PE over a business cycle. You really have to go back 10-12 years to get a feel for what average margins typically look like in these businesses. That's what you use for earnings. The second thing, when you look at a PE, you're always assuming it's sustainable. You always want to make sure it's protected either by assets or the kind of moat that Buffet talks about. Otherwise, even if it's been making lots of money, it's a business that will be competitively vulnerable.

Does the weak credit environment change the value investing proposition?

The first thing is that for value investors, you are not going to try to forecast the future. Most value investors would say if it's anything like credit crunches we've seen in the past, it will be gone in a year. That's what the betting has to be. It's a short-term problem and not something you focus on. It has, however created opportunities in debt markets. Banks are dumping senior secured debt, selling it on the market for 50-60-70 cents on the dollar. The implied returns are north of 15 percent, and because you're senior to everybody else in the event of bankruptcy, you're likely to get paid. That's where opportunities have been created by the credit crunch. If you listen to Buffet, it's where he's been investing up until now. Those opportunities are still there, but my guess is they're going to go a way.

Any advice for inve s tors who a re still nervous?

If you look at any (mutual) fund and you look at the average annual return—a dollar invested every year through the life of the fund—and then you look at the returns weighted by how much money was in the fund . . . , the difference in those two returns is 6 percent a year. That's true almost across every category of funds. What that means is investors are buying in at exactly the wrong time and dumping things at the exactly wrong time. In this environment, the people who are dumping things are getting out at almost exactly the wrong time. What you want to have is a steady, well-developed policy you stick to.

What do you think of Warren Buffett's move so far into Goldman Sachs and General Electric?

First of all, Goldman and GE are not real Warren Buffett moves. They're literally what he did at Solomon Brothers. He got paid very handsomely both in terms of a high return and protection on the downside. His preferred carries a significant interest return on it and is protected in event of a catastrophe. He got a very favorable deal. This is not the kind of real investment he's making. He has talked about accumulating further positions in one of two financial services companies. I don't know if he's had to reveal which one yet, but it's either American Express or Wells Fargo.

There you can see what he's looking at. American Express is easier because it doesn't have all the complexity of a bank.

Greenwald on the best value bets in the market now:

American Express: If you ask yourself what the average yearly earnings should be even in a fairly distressed economic environment, it's probably about $3.50 a share. Typically, they commit to pay out at least half of those earnings to you in cash, so you're getting a 7 percent cash return either in buybacks or the dividend. Then they reinvest 7 percent of your money. In the short run, where that money is going is cash to protect themselves financially against any catastrophic drop in credit card repayments, but in the long run it's going to credit card loans, and the economics of those are fairly transparent: They lend at 15 percent, borrow at 4 or 5 percent, have a 10 percent margin, and the default rate is around 5 percent. So they make 5 percent on every dollar of loans, and they leverage up because you can because it's fairly safe. Even if they do 7 to 1, which is a fairly conservative ratio, you're making 5 percent times seven on your unemployed equity capital which is 35 percent, or 20-percent-plus post-tax. And billings by American Express just grow over time. It's probably faster than GDP because they have high-income customers, and spending is skewed towards services, which are growing faster than (spending) on goods. You probably get another 5 percent even making conservative growth (projections). You're looking at returns, without any improvement in the multiple, of well over 20 percent. That's the sort of investment (Buffett) sees. It gives you an enormous margin of safety for long-lived bad economic conditions.

WellPoint: You've got an annual earnings return of 14 to 15 percent, and mostly its going into cash. You know they're just a toll on medical expenditures in certain parts of the country, and those will be growing at 5 percent no matter how you look at that. That's a 20 percent return. Buffett's not greedy. He'll live with that all day long. These are safe companies with dominant market positions and trustworthy managements. They may go down in value before they go up, but the long-run prospects are so stable and attractive that I think he's right to be investing in these things.

Magna: It recently traded at a market capitalization of $3.6 billion, and it's got $1.7 billion in net cash. They're not going to run out of money, so you're paying $1.8 billion or $1.9 billion for the business. That business this year, if you look at average margins—and this year it's a little lower because they're at the trough of the cycle—is going to earn about 5 percent on sales of about $26 billion, so you're talking about $1.3 billion of pretax earnings you can buy for $1.9 billion. Then, if you look at the assets and the cost of reproducing those, you have about $8 billion of assets in the business to protect you. If you just take that earnings power, after tax, of about $1 billion, and you say in a risky industry like autos you want a 12 percent return, that's an 8 multiple. That's a case where you're being very conservative about earnings, you're backed by assets, there's a lot of cash, and, even though autos are a fraught place to be, you're buying those $8 billion in assets less than $2 billion. That's got to be the kind of bargain you're looking for.

Comcast

Comcast, when you take out excess depreciation, is trading at an earning return of about 10 percent. Even if everything goes to hell in a basket, the one thing we'll do is transact over the Internet. They and the phone companies have an incredibly valuable monopoly unless they screw it up. The one encouraging thing that hasn't appeared in cable company [share] prices is price wars among some companies seem to be moderating.

Microsoft

Microsoft, if you take out $20-30 billion in cash, is trading at about a 10 percent earnings return or so. It's a business that doesn't require any incremental capital and will grow at least as fast as global GDP.

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